

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 97-0169 ITC

**Adjusted Gross Income Tax — Patronage Dividends
Adjusted Gross Income Tax — Property Tax
Gross Income Tax — Patronage Dividends
Adjusted Gross Income Tax — Interest
Tax Administration — Penalty**

For Tax Periods: 1993 and 1994

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax — Patronage Dividends

Authority: IC 8-1-17 *et.seq.*; IC 6-3-3-3.5(b)
IRS Revenue Ruling 83-135
IRC section 1381 (a)(2)(c)

Taxpayer protests the inclusion of "patronage dividends" in its Indiana adjusted gross income.

II. Adjusted Gross Income Tax — Property Tax

Authority: 45 IAC 3.1-1-8

Taxpayer protests the inclusion of property taxes paid in its Indiana adjusted gross income.

III. Gross Income Tax — Patronage Dividends

Authority: IC 6-2.1-1-2

Taxpayer protests lack of credit given for "patronage dividends" included in its Indiana gross income.

IV. Adjusted Gross Income Tax — Interest

Authority: IC 6-3-1-3.5(b)
45 IAC 3.1-1-8(1)

Taxpayer protests the inclusion of interest received from holdings in United States debt instruments in its Indiana gross income.

V. Tax Administration — Penalty

Authority: IC 6-8.1-10-2; IC 6-8-10-2.1
45 IAC 15-11-2; 45 IAC 2.2-3-20

Taxpayer protests the imposition of a ten-percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer, currently organized as a telephone cooperative, provides telecommunication services to its members. Prior to 1992, taxpayer operated as a "C" corporation. Effective January 1, 1993, taxpayer re-incorporated under the Indiana Rural Telephone Cooperative Act.

On July 20, 1993, taxpayer applied for, and was granted, 501(c)(12) not-for-profit status by the Internal Revenue Service ("IRS"). As a not-for-profit, taxpayer was instructed by the IRS to file federal returns using Form 990. However, as taxpayer was unable to meet the eighty-five (85) percent requirement of 501(c)(12)-1, taxpayer could not take advantage of its exempt status. Consequently, taxpayer filed its state and federal returns using, respectively, Form IT 20 and Form 1120. On its returns, taxpayer reported only income unrelated to its basic telephone service operations. Taxes were paid on this unrelated income. Taxpayer had eliminated all net income related to subscriber (patron) income by placing it into a retained earnings account. Taxes were not paid on this income.

Audit took issue with taxpayer's exclusion of all related business income in its adjusted gross income calculus. (Taxpayer included all income – both related and unrelated - in determining its gross income.) Since taxpayer filed its federal returns on Form 1120, Audit chose to treat taxpayer as a regular "C" corporation for gross, adjusted gross, and supplemental net income tax

purposes. Such treatment resulted in additional assessments of tax covering excluded net income, property taxes not added back, and some miscellaneous interest income.

I. Adjusted Gross Income Tax — Patronage Dividends

DISCUSSION

Taxpayer protests the inclusion of "patronage dividends" in its Indiana adjusted gross income.

Taxpayer, a telephone cooperative, excludes from its adjusted gross income patronage dividends. As calculated, patronage dividends represent a net income figure. Taxpayer computes these dividend amounts by subtracting all business-related costs and expenses from its patronage income. According to taxpayer, these dividends are properly excluded from adjusted gross income because they are not actually income. Rather, these dividends represent a reduction in the price paid by patrons for telephone services received. Taxpayer notes the Internal Revenue Service's (IRS) agreement with this position.

In Revenue Ruling 83-135, the IRS held that a *taxable* cooperative - one not subject to the provisions of subchapter T - may *exclude* from its gross income patronage dividends paid or allocated in accordance with issued bylaws. The IRS emphasized that for patronage dividends to be excluded, the dividends must be paid or allocated pursuant to a "pre-existing legal obligation in proportion to patronage." And since the IRS discovered language in the cooperative's bylaws creating a pre-existing legal obligation, the IRS found the exclusion proper.

Taxpayer argues its situation is analogous to that of the aforementioned party. Specifically, taxpayer - unable to take advantage of its 501(c)(12) status because of the eighty-five (85) percent rule - is a taxable cooperative. And as a telephone cooperative, taxpayer is not subject to the provisions of subchapter T. (See section 1381 (a)(2)(c) of the IRC.) Additionally, taxpayer recognizes a legal obligation to return patronage dividends - dividends calculated and allocated on a pro rata basis.

The analogy fails, however, when one considers the source of taxpayer's pre-existing legal obligation. Taxpayer's bylaws were silent on the issue of patronage dividends. However, as taxpayer was incorporated under the provisions of the Indiana Rural Telephone Cooperative Act, the Department looks to that Act for evidence of any legal obligations.

The salient language of the Rural Telephone Cooperative Act, codified at IC 8-1-17 *et. seq.*, informs:

Revenues and receipts not needed for the above and foregoing purposes [purposes required to enable a telephone cooperative to furnish reasonably adequate telephone services and facilities], or not needed in reserves for such purposes, *shall be returned to the patrons on a pro rata basis according to the amounts paid by them for telephone service; such returns shall be either in cash or in abatement*

of current charges for telephone service, as the board may decide. See IC 8-1-17-20. (Emphasis added.)

The Department notes that for corporations, Indiana adjusted gross income is the same as "taxable income" (absent adjustments) as defined in Section 63 of the Internal Revenue Code. (See IC 6-3-3-3.5(b).) Given the language of IRS Revenue Ruling 83-135 - language excluding patronage dividends from federal gross income - the Department finds that income representing patronage dividends should also be excluded from taxpayer's Indiana adjusted gross income.

FINDING

Taxpayer's protest is sustained.

II. Adjusted Gross Income Tax — Property Tax

DISCUSSION

Taxpayer protests Audit's inclusion of property taxes paid in taxpayer's Indiana adjusted gross income.

Several audit adjustments were made to taxpayer's Indiana adjusted gross income. Included among these adjustments was an addition of \$1,980.00. This amount represented property tax deducted from taxpayer's federal taxable gross income but not added back to its Indiana adjusted gross income. Taxpayer, however, maintains the amount was added back.

On taxpayer's 1994 Indiana corporate income tax return (Form IT 20), taxpayer added back \$29,143.00 of property taxes. (See line 25, Schedule B entitled "Add back: All real estate and personal property taxes.") Taxpayer states this figure includes the contested \$1,980.00. Later, as the result of a subsequent audit, taxpayer's adjusted gross income was increased by \$610,910.00. This amount also included the \$1,980.00 figure. Audit characterized the property tax in question as a Schedule M-1 deduction that was not charged against book income — i.e., not expensed. Consequently, Audit concluded the amount had not been added back to taxpayer's Indiana adjusted gross income — that is, not included in the \$29,143.00 figure.

Taxpayer recognizes the necessity to add back property taxes deducted from its federal gross income to its Indiana adjusted gross income. As 45 IAC 3.1-1-8 instructs:

Sec. 8. "Adjusted Gross Income" for Corporations Defined. "Adjusted Gross Income" with respect to corporate taxpayers is "taxable income" as defined in Internal Revenue Code—section 63 with three adjustments:

(3) Add back deductions taken pursuant to Internal Revenue Code section 63 for:

(a) Taxes based on or measured by income and levied at the state level. For

purposes of this subsection, the Indiana Gross Income Tax is a state tax measured by income and must be added back (see *Miles v. Department of Treasury*, 209 Ind. 172 (1935));

(b) Property taxes levied by a political subdivision of any state; and

(c) Indiana motor vehicle excise taxes, except for that portion of the tax not considered an ad valorem tax.

During this inquiry, neither taxpayer nor Audit has provided work papers or other documents supporting their respective conclusions. The Department requests Audit to revisit this issue.

FINDING

Taxpayer's protest is sustained to the extent that taxpayer can show the contested amount was previously added back to its 1994 Indiana adjusted gross income.

III. Gross Income Tax — Patronage Dividends

DISCUSSION

Taxpayer included in its 1993 and 1994 Indiana gross income all receipts classified as patronage dividends. Taxpayer now believes these amounts were in error. Specifically, taxpayer argues that income representing patronage dividends should not have been included in its Indiana gross income.

Taxpayer presents two arguments in support of exclusion. First, taxpayer argues, revisiting its adjusted gross income position, that income representing patronage dividends should be excluded from Indiana gross income pursuant to IRS Revenue Ruling 83-135. Taxpayer insists this IRS ruling can not be so narrowly construed as to limit its application to Indiana adjusted gross income. Rather, taxpayer argues this ruling should serve to exclude patronage dividends from Indiana gross income as well.

Second, as acknowledgement of the differences between Indiana gross income and Indiana adjusted gross income, taxpayer offers an alternative argument - one based on Indiana statutory language. To wit, taxpayer cites IC 6-2.1-1-2(c)(14) for the proposition that "patronage dividends," as capital contributions, must be excluded from its Indiana gross income.

Specifically, IC 6-2.1-1-2(c)(14) states:

(c) The term "gross income" does not include"

(14) the receipt of capital by a corporation, partnership, firm, or joint venture, or contributions to the capital thereof;

In place of narrative, taxpayer offers Section 7.02 of its bylaws – dated April 6, 1998 – as an accurate description of how subscriber income became patronage capital contributions for the 1993 and 1994 tax years. The relevant part of Section 7.02, entitled “Patronage Capital in Connection with Furnishing Telephone Service,” states:

The Corporation’s operations shall be conducted so that all patrons will, through their patronage, furnish capital for the Corporation. The Corporation will account on a patronage basis to all its patrons for all amounts received and receivable from the furnishing of telephone service in excess of operating costs and expenses properly chargeable against the furnishing of telephone service. All such amounts in excess of operating costs and expenses at the moment of receipt by the Corporation are received with the understanding they are furnished by the patrons as capital. The Corporation is obligated to pay by credits to a capital account for each patron all such amounts in excess of operating costs and expenses.

Taxpayer receives income from its patrons for telephone services rendered. At the end of the year, taxpayer then allocates its net income – i.e., the income from patrons that exceeds operating costs and expenses – as patronage dividends. These dividends, initially, are allocated and retained in each patron’s capital account. From there, the money may be returned to the patron if (i) it is not used by taxpayer to offset losses incurred in current or prior years, and (ii) the capital account exceeds a maximum as determined by the cooperative’s Board of Directors.

The Department finds these receipts were properly included in taxpayer’s Indiana gross income pursuant to IC 6-2.1-1-2. At the time of receipt, this income represented service income. It was only after taxpayer’s tax year that a determination could be made as to what portion of patron income would be returned as a patronage dividend. That taxpayer chose to allocate dividends to patron’s capital accounts rather than to return the dividends “in cash or in abatement of current charges for telephone service” does not change the nature of the original transaction. The income that taxpayer received from patrons as service income, and subsequently *returned to* patrons as patronage dividends, can not be excluded from taxpayer’s Indiana gross income as capital contributions *received from* those patrons.

As to taxpayer’s initial argument, while Indiana adjusted gross income may track “taxable income” as defined by the I.R.C. section 63,” such is not the case with regard to Indiana gross income. Absent specific statutory language indicating otherwise, all income is to be included in an Indiana corporation’s gross income. Revenue Ruling 83-135 does not serve to shelter taxpayer from this requirement.

FINDING

Taxpayer's protest is denied.

IV. Adjusted Gross Income Tax — Interest

DISCUSSION

Taxpayer protests Audit's addition to taxpayer's adjusted gross income of interest received from investments in United States debt instruments.

Audit disallowed taxpayer's deduction of \$15,790 from its 1994 Indiana adjusted gross income. This figure represented income received from investments in United States debt obligations. Audit based its denial on taxpayer's inability to document the source of this income. Taxpayer now contends that \$3,183 of the previously disallowed total represents income from investments in two mutual funds - the Putnam U.S. Government Income Fund and the Nation's Government Fund. From taxpayer's perspective, this income, as interest earned from investments in United States obligations, should be deducted from its Indiana adjusted gross income.

Under IC 6-3-1-3.5(b) and 45 IAC 3.1-1-8(1), income exempt from taxation under the U.S. Constitution and "statutes of the United States" is to be deducted from taxpayer's Indiana adjusted gross income. This exemption is broad enough to include interest received from mutual funds holding United States obligations.

As stated in *Income Tax Information Bulletin #19* (July 1992):

The proportionate share of dividends or interest received from a Mutual Fund, Money Market Fund, Regulated Investment Trust or other investment fund derived from investments in direct U.S. government obligations will be allowed as a deduction in the computation of Indiana gross income tax and Indiana adjusted gross income tax. This deduction will be allowed to the extent such income is included in Indiana gross income or Indiana adjusted gross income.

Taxpayer has submitted a letter from its broker indicating that 20.03 percent of income received from the Putnam U.S. Government Income Fund was earned from investments in United States treasury obligations. Taxpayer, however, has been unable to document the source of income received from its Nation's Government Fund investment.

FINDING

To the extent taxpayer's adjusted gross income included income representing 20.03 percent of its earnings from investments in the Putnam U.S. Government Income Fund, taxpayer's protest is sustained. However, to the extent any of the included amounts represent income received from taxpayer's investment in the Nation's Government Fund, the protest is denied.

V. Tax Administration — Penalty

DISCUSSION

The taxpayer protests the imposition of the ten-percent (10%) negligence penalty.

The negligence penalty imposed under IC 6-8.1-10-2.1(e) may be waived by the Department where reasonable cause for the deficiency has been shown by the taxpayer. Specifically:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-2.1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. 45 IAC 15-11-2(e).

While taxpayer has not prevailed on all protested issues, taxpayer has offered legally cognizable arguments. Taxpayer's actions, coupled with its legal justifications, meet the reasonable cause threshold. The Department finds, therefore, that the negligence penalty should be waived.

FINDING

Taxpayer's protest is sustained.